

## ANALYSIS OF ORIGINAL BILL

Author: Baldwin Analyst: Marion Mann DeJong Bill Number: AB 1841

Related Bills: See Legislative History Telephone: (916) 845-6979 Introduced Date: 02/12/98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Mortgage Savings Account Credit

### SUMMARY

Under the Personal Income Tax Law (PITL), this bill would allow individuals who have never purchased a principal residence to claim a 10% credit for deposits to a mortgage savings account (similar to an individual retirement account).

### EFFECTIVE DATE

As a tax levy, this bill would become effective immediately and would apply to taxable years beginning on or after January 1, 1998. Specified language in the bill provides that the credit would not be available for taxable years beginning on or after January 1, 2002.

### LEGISLATIVE HISTORY

AB 223 (1989/90), AB 3363 (1989/90).

### BACKGROUND

Federal law allows states to sell tax-exempt bonds with the proceeds to be used to make first-time homebuyer mortgage loans to lower-income working individuals. The California Housing Finance Agency (CHFA) was created to take advantage and manage this process for California. CHFA sells the bonds, makes the mortgage loans, collects the mortgage loan payments and repays the bonds.

The buyers of the CHFA mortgage revenue bonds accept a lower rate of interest on their housing bond investment than if they had to pay taxes on the bond interest earnings. CHFA passes the interest rate savings on to the first-time homebuyer. As a result, first-time homebuyers pay significantly lower interest rates on their loans than they would have to pay if the loans were from a bank or other financial institution. This lowers the cost of a loan by as much as one percentage point.

### DEPARTMENTS THAT MAY BE AFFECTED:

\_\_\_ STATE MANDATE

\_\_\_ GOVERNOR'S APPOINTMENT

#### Board Position:

\_\_\_ S \_\_\_ O  
\_\_\_ SA \_\_\_ OUA  
\_\_\_ N \_\_\_ NP  
\_\_\_ NA \_\_\_ NAR  
\_\_\_X\_\_\_ PENDING

#### Agency Secretary Position:

\_\_\_ S \_\_\_ O  
\_\_\_ SA \_\_\_ OUA  
\_\_\_ N \_\_\_ NP  
\_\_\_ NA \_\_\_ NAR  
DEFER TO \_\_\_

#### GOVERNOR'S OFFICE USE

Position Approved \_\_\_  
Position Disapproved \_\_\_  
Position Noted \_\_\_

Department Director Date  
Gerald H. Goldberg 3/13/98

Agency Secretary Date

By: Date

CHFA loans are only available to first-time homebuyers. A first-time homebuyer is anyone who has not owned a home in the previous three years and who will be living in the CHFA-financed home as his or her only place of residence. First-time homebuyers cannot earn more than the median family income for the state or county where they buy, except that families of three or more can earn up to 115% of the median family income.

The cost of a CHFA financed home cannot be more than 90% of the average home purchase price for the county in which the home is located. However, the CHFA loan can be as high as 97% of the purchase price of the home, requiring only a 3% down payment. CHFA loans can be 30 years at either a fixed or adjustable interest rate.

There is also a recapture penalty for the CHFA borrower who could afford to wait and buy using a loan from a bank or other conventional lender. A CHFA borrower who has an income which raises more than 5% a year above the CHFA income limit must pay a federal income tax of up to half of any profit gained from reselling the home within nine years.

#### SPECIFIC FINDINGS

**Under federal and state law**, a taxpayer can deduct up to \$2,000 per year for contributions made to a deductible Individual Retirement Account (IRA). This amount applies to all individuals who were not active participants in an employer-sponsored retirement plan. An individual who is an active participant in an employer-sponsored retirement plan may deduct the full \$2,000 if the individual's adjusted gross income (AGI) is below certain limits.

**Federal and state laws** impose a penalty (10% federal, 2.5% state) on early distributions received by an individual in connection with his or her IRA. Early distributions include (1) any actual distribution to a person not yet 59½ years of age and (2) income earned in the year on excess contributions when returned before the due date of the return.

The penalty does not apply to certain distributions, including the following:

- portions of any distributions treated as a return of nondeductible contributions;
- distributions used to pay for qualified higher educational expenses or first-time homebuyer expenses.
- distributions made after the owner's death;
- distributions made because the owner became disabled;
- distributions that are part of a series of substantially equal payments over the owner's life (or life expectancy), or over the lives of the owner and the owner's beneficiary (or life expectancies); and
- distributions that are rolled over into another qualifying plan.

First-time homebuyer withdrawals must be used to buy, build, or rebuild a home within 120 days of distribution. A "first home" is the principal residence of the taxpayer, child, grandchild, or ancestor of the taxpayer. Acquisition costs include any usual or reasonable settlement, financing, or other closing cost. A first-time homebuyer is an individual (and spouse, if married) who must not have

an ownership interest in a principal residence during the two-year period ending on the date the new home is purchased. The maximum amount of IRA distribution a taxpayer may receive in a lifetime and use for first-time homebuyer expenses is \$10,000.

**Federal and state laws** provide various tax credits that are designed to provide tax relief for taxpayer who incur certain expenses (e.g., child and dependent care credits) or to influence behavior, include business practices and decisions (e.g., research credit, manufacturers' investment credit).

**This bill** would allow individuals who have never purchased a principal residence to claim a 10% credit for deposits to a mortgage savings account, similar to an IRA. The credit would be limited to the lesser of \$200 (\$400 for a joint return) or 10% of the individual's (or both spouses' for a joint return) total compensation includable in gross income for the taxable year. No deposit to a mortgage savings account would be allowed for the taxable year in excess of the maximum amount for which a credit is allowed.

A mortgage savings account would be an account established by a qualifying individual (or a qualifying individual and a spouse, jointly) and designated as a mortgage savings account by the trustee or custodian. The mortgage savings account requirements would be similar to an IRA.

A qualifying individual would mean an individual who meets, at the time of any deposit, the income limit eligibility standards established by the CHFA pursuant to the California Housing Finance Agency Resale Plan.

**This bill** would exempt any interest earned on a mortgage savings account from taxation until it is withdrawn from the account. However, unlike an IRA, no deduction would be allowed for deposits to the account.

Withdrawals from a mortgage savings account, not previously included in income by a qualifying individual, would be included in gross income for the taxable year in which the payment or distribution is received, unless that amount either (1) qualifies as a rollover contribution, as defined, or (2) is used exclusively to purchase a principal residence in California, including:

- All escrow costs, real estate fees and commissions; and
- Real estate expenses in connection with the acquisition or construction of the land, house, fixtures, improvements, or landscaping.

Any withdrawal from a mortgage savings account would first be considered to be a withdrawal of any interest earned.

Withdrawals from a mortgage savings account, if not used to purchase a principal residence, would be subject to a 10% penalty. The penalty would not apply if the withdrawal was due to financial hardship such as: major accidents, illnesses, disabilities, the death of a spouse, extended unemployment, large casualty losses, or other personal hardships as determined by the Franchise Tax Board (FTB).

The basis of any residence purchased with funds withdrawn from a mortgage savings account (not previously included in income) would be reduced by the amount of those funds.

**This bill** would require the depository maintaining the mortgage savings account to report regarding contributions, distributions and any other matter FTB requires regarding that account to the FTB and the individual for whom the account is maintained.

**This bill** would not allow excess credits to be carried over to future years.

#### Policy Considerations

This bill would raise the following policy considerations.

- Although this bill would assist first-time homebuyers, without a similar federal plan there may not be sufficient incentive to set up mortgage savings accounts.
- Since the 10% penalty only applies to previously unreported interest, taxpayers could manipulate the timing of deposits and withdrawals to benefit from the credit. For example, taxpayers could make a \$2,000 deposit on one day, withdraw it the next day and claim a \$200 tax credit. The taxpayer would be subject only to a 10% penalty for one day of interest earned on \$2,000.
- This bill would impose tax and penalty on the *entire* amount withdrawn from a mortgage savings account if the *entire* amount is not "rolled over" and deposited into a new mortgage savings account. For IRAs, tax and penalties are imposed only on the *portion* of the IRA not rolled over.
- Since federal and state law was recently amended to allow the withdrawal of funds from an IRA for first-time homebuyers without penalty, this bill may cause confusions.

#### Implementation Considerations

This bill would raise the following implementation considerations. Department staff is available to assist the author with any necessary amendments.

- It is unclear whether the maximum deposit for which a credit is allowable is \$2,000 or \$200.
- The terms "compensation," "principal residence," "financial hardship," "major accident," "illness," "disabilities," "extended unemployment," "large casualty loss" and "other personal hardship" are not defined. Undefined terms can lead to disputes between taxpayers and the department.
- It is unclear how the provisions of this bill would apply to qualifying individuals who marry unqualified individuals.

- It is unclear whether two unmarried qualifying individuals could deposit amounts into separate mortgage savings accounts and withdraw the amounts to purchase a single home.
- It is unclear what happens to an account if the individual dies or moves out of California.
- The bill does not specify whether a time element is required from the date of distribution to the time of expenditure on qualifying cost of a new home.
- The bill provides that the individual must meet certain eligibility standards at the time of "any" deposit into the mortgage savings account. This could be read to mean that if an individual meets the eligibility standards "one" time in connection with numerous deposits, all deposits would qualify for the credit.
- The bill provides that the individual must meet the income limit eligibility standards established by the CHFA; it does not specify whether this means the eligibility standards in effect when the bill is enacted or each year of the credit. It is department staff's understanding that the CHFA provides annual income limit eligibility standards.
- The bill provides that the credit shall only apply to residences that are located in California. It is unclear whether an individual who owned a residence outside of California would qualify as a first-time homebuyer. Further, it is unclear whether a nonresident could establish a mortgage savings account if he or she intends to move to California and purchase a home.

#### Technical Considerations

Amendment 1 would remove an unnecessary word.

Amendment 2 would remove the unnecessary authorization for FTB to promulgate regulations. FTB is currently authorized to promulgate regulations that are necessary for the proper administration of the Revenue and Taxation Code.

#### FISCAL IMPACT

##### Departmental Costs

If amended to resolve the department's implementation considerations, this bill would not significantly impact the department's costs.

##### Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in revenue losses as shown in the table. The proposed mortgage savings account would compete for deposits with other existing savings accounts offering

advantages for first-time homebuyers such as penalty-free withdrawals from tax-deductible IRAs and Roth IRAs.

Estimated Revenue Impact of AB 1841 Effective January 1, 1998 (\$ In Millions)		
1998-99	1999-00	2000-01
(\$1)	(\$1)	(\$1)

The bill would be effective with taxable years beginning after December 31, 1997, with enactment assumed after June 30, 1998.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

#### Tax Revenue Discussion

The revenue impact of this bill would be determined by (1) the number of "qualifying individuals" who make deposits to mortgage savings accounts, (2) the amount each qualifying individual deposits, (3) the amount of credits generated that could be applied to reduce tax liabilities, and (4) the amount of interest income earned on deposits in mortgage savings accounts that would be exempted from tax.

Using personal income tax sample data, the potential universe of qualifying individuals was determined by tabulating taxpayers meeting the following criteria: (1) adjusted gross income of \$52,500 or less, (2) claimed the standard deduction, (3) interest income of \$45 or more, (4) a tax liability with which to apply a credit, and (5) younger than age 65. The rationale for certain specified criteria are discussed below. The tabulation produced a total of 15,000 taxpayers. Of these, approximately two-thirds are married couples and one-third are individuals. According to housing research, being married increases the chances of homeownership.

If 20% of qualifying couples and 10% of qualifying individuals establish a mortgage savings account and make average annual deposits of \$2,000 per couple and \$1,000 per individual, credits totaling \$450,000 would be generated. The bill does not require a minimum holding period for claiming the credit on deposits. If an equal number of qualifying couples and individuals transfer existing savings to these accounts immediately before purchasing a home, the additional impact would be \$450,000. For the bill as introduced, the estimate assumes the majority of credits could be applied to reduce tax liabilities.

For purposes of identifying the potential universe of qualifying individuals, the rationale for certain specified criteria is as follows:

- Adjusted gross income of \$52,500 or less: To be eligible for the credit, the taxpayer's income must be within the CHFA's income limits at the time the deposit is made. Although this limit varies by county, the median gross income limit is \$52,500.

- Claim the standard deduction: By selecting tax returns with the standard deduction, the vast majority of existing homeowners are eliminated. Most homeowners itemize deductions to claim mortgage interest and property tax.
- Interest income of \$45 or more: This nominal amount of interest income is indicative of minimal savings (or reserves) of approximately \$1,500 and reflects the required discipline for making deposits to a mortgage savings account.
- Tax liability with which to apply a credit: The bill is silent with respect to a carryover of unused credits.
- Younger than age 65-years: This reflects an assumption that qualifying individuals would most likely be younger than age 65.

BOARD POSITION

Pending.

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Doug Bramhall

FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 1841  
As Introduced February 12, 1998

AMENDMENT 1

On page 3, modify lines 12 and 13 as follows:

account by the trustee or custodian. A mortgage ~~or~~ savings account shall be subject to the same requirements

AMENDMENT 2

On page 5, modify lines 9 through 14 as follows:

contributions, distributions, and any other matters ~~which the Franchise Tax Board may require under regulations~~ in the form and manner prescribed by the Franchise Tax Board. The reports required by this subdivision shall be filed ~~at the time and in the manner~~ and furnished to individuals at the time and in the manner ~~as may be required by those regulations~~ prescribed by the Franchise Tax Board.